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MEMORANDUM
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TO: Docket Control

FROM: Steven M. Olea
Director
Utilities Division

ARIZONA CORPORATION COMMISSION
DOCKET CONTROL

DATE: March 14, 2013

RE: IN THE MATTER OF THE APPLICATION OF ARIZONA TELEPHONE COMPANY FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, AND TO INCREASE RESIDENTIAL RATES AS NECESSARY TO COMPENSATE FOR THE RATE IMPACTS OF THE FCC'S USF/ICC TRANSFORMATION ORDER. (DOCKET NO. T-02063A-12-0473)

Attached is the Staff Report for Arizona Telephone Company's application to increase residential rates to compensate for the rate impacts of the Federal Communications Commission's Universal Service Fund/Intercarrier Compensation ("FCC's USF/ICC") Transformation Order.

Staff recommends approval of Arizona Telephone Company's request to increase its monthly residential local exchange service rate from \$10.00 to \$14.00, effective June 1, 2013.

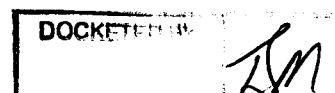
SMO:AFF:tdp\MAS

Originator: Armando Fimbres

Arizona Corporation Commission

DOCKETED

MAR 14 2013



SERVICE LIST FOR: ARIZONA TELEPHONE COMPANY
DOCKET NO.: T-02063A-12-0473

Mr. Craig A. Marks
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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

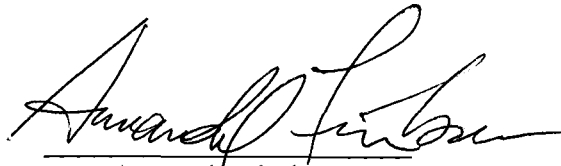
**ARIZONA TELEPHONE COMPANY
DOCKET NO. T-02063A-12-0473**

**IN THE MATTER OF THE APPLICATION OF ARIZONA TELEPHONE COMPANY
FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR
VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, AND TO INCREASE
RESIDENTIAL RATES AS NECESSARY TO COMPENSATE FOR THE RATE
IMPACTS OF THE FCC'S USF/ICC TRANSFORMATION ORDER.**

MARCH 14, 2013

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Telephone Company (Docket No. T-02063A-12-0473) was the responsibility of the Staff member listed below.

A handwritten signature in black ink, appearing to read "Armando Fimbres", written over a horizontal line.

Armando Fimbres
Executive Consultant III

**EXECUTIVE SUMMARY OF
ARIZONA TELEPHONE COMPANY
DOCKET NO. T-02063A-12-0473**

On November 23, 2012, Arizona Telephone Company (“Arizona Telephone” or “Applicant”) filed an application for a determination of its earnings and the fair value of its investment and requested that its residential rates be increased to compensate for the rate impacts of the Federal Communication Commission’s (“FCC’s”) November 18, 2011, Universal Service Fund/Intercarrier Compensation (“USF/ICC”) Transformation Order (“USF/ICC Order”) pursuant to Arizona Revised Statute (“A.R.S.”) § 40-250 and the Arizona Corporation Commission’s (“Commission’s”) Arizona Administrative Code (“A.A.C.”) R14-2-103.

Staff recommends that the Arizona Telephone monthly residence local exchange rate increase from \$10.00 to \$14.00 to address the impact of the FCC’s USF/ICC Order. Staff believes the proposed increase is just, fair and reasonable for the following reasons:

- The increase is necessitated by the FCC’s November 18, 2011 USF/ICC Order;
- The increase is necessary to preserve the entirety of the Federal Universal Service Fund (“FUSF”) funds that may flow to Arizona Telephone pursuant to the FCC’s rules;
- The increase will minimize/reduce the amount of future rate increase; and
- The increase will allow the Applicant to receive matching funds from the FUSF.

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INTRODUCTION

On November 23, 2012, Arizona Telephone Company (“Arizona Telephone” or “Applicant”) filed an application for a determination of its earnings and the fair value of its investment and requested that its residential rates be increased to compensate for the rate impacts of the Federal Communication Commission’s (“FCC’s”) November 18, 2011, Universal Service Fund/Intercarrier Compensation (“USF/ICC”) Transformation Order (“USF/ICC Order”) pursuant to Arizona Revised Statute (“A.R.S.”) § 40-250 and the Arizona Corporation Commission’s (“Commission’s”) Arizona Administrative Code (“A.A.C.”) R14-2-103. A.A.C. R14-2-103(A)(1) requires specific financial and statistical information be filed with a request by a public service corporation doing business in Arizona for a determination of the value of the property of the corporation and of the rate of return earned. Arizona Telephone submitted, as recommended by Staff, a streamlined filing in which Arizona Telephone submitted the following six exhibits to support the requested increase in residential rates:

- Adjusted Results Twelve Months Ending June 30, 2012
- Adjustments
- Year 1 FCC Order ICC Impact
- Rate Base
- Working Capital
- Rate Design.

BACKGROUND

Arizona Telephone is a corporation duly organized and existing under and by virtue of the laws of the State of Arizona. Arizona Telephone is authorized to engage in and is engaged in the conduct of a general communications business within the State of Arizona. Arizona Telephone is a rate-of-return (“RoR”) regulated incumbent local exchange carrier (“ILEC”) serving non-metro communities.

On November 18, 2011, the FCC issued the USF/ICC Order. The USF/ICC Order transitions the outdated federal universal service programs and most intercarrier compensation systems into a new Connect America Fund (“CAF”). The FCC’s press release characterized the USF/ICC Order as “the most significant policy step ever taken to connect all Americans to broadband.”

In its USF/ICC Order, the FCC stated that it will reduce intercarrier compensation rates to zero by July 1, 2020, for RoR companies, with limited recovery from customers and partial recovery from the CAF. The recovery from the CAF will phase out over time at 5 percent annually. The USF/ICC Order adds new rules that will reduce federal high-cost loop support ("FHCLS") to carriers by the amount their flat-rate single line residential local service rates fall below a specified local service rate floor. The rate floor includes state subscriber line charges, state universal service fees, and mandatory extended area service charges, if any are assessed. The FCC's order establishes single line residential local service rate floors of \$10.00 as of June 1, 2012, \$14.00 as of June 1, 2013, with the floor thereafter being determined annually by the FCC's Wireline Competition Bureau, based on a nationwide average.

To maintain FHCLS, Arizona Telephone and other rural ILECs must increase single line residential local rates to the FCC-mandated residential rate floors. Otherwise, the amount of FHCLS funds will be reduced dollar-for-dollar for each customer by the difference between the existing single line local rate and the new rate floor. If single line local rates are not increased, the new FCC rules will reduce FHCLS for Arizona Telephone and other applicable ILECs.

The Commission last considered Arizona Telephone's rates in Docket No. T-02063A-12-0302, which resulted in Commission Decision No. 73575, dated November 21, 2012. Decision No. 73575, authorized Arizona Telephone residence rates to be raised to the rate floor of \$10.00. With this application, Arizona Telephone seeks Commission approval to raise its rates to the rate floor of \$14.00 by June 1, 2013.

CONSUMER SERVICES

On November 28, 2012, the Commission's Corporations Division responded that Arizona Telephone is in Good Standing. A review of Consumer Services database revealed that no complaints, inquiries and opinions were received pertaining to Arizona Telephone for the period January 1, 2009 thru November 28, 2012.

COMPLIANCE

A check of the Utilities Division Compliance Section database showed that Arizona Telephone is in compliance with all items.

OPERATING INCOME STATEMENT

Arizona Telephone submitted Adjusted Regulated Results of Operations for Twelve Months Ending June 30, 2012 information in its streamlined filing. The submitted information was accepted without adjustment for the purposes of this streamlined application.

Operating Revenue and Expenses

According to the information provided by the Applicant, Arizona Telephone Total Intrastate Operating Revenues for the Twelve Months Ending June 30, 2012 were \$1,121,018. Subcategories of Total Intrastate Operating Revenues are noted below:

Local	\$576,031
USF-HCL ¹ & Safety Net	\$106,060
Access Revenues	\$382,376
Other	\$56,551

The Company also stated that its Total Intrastate Operating Expenses for the Twelve Months Ending June 30, 2012 were \$1,865,480. Subcategories of Total Intrastate Operating Expenses are noted below:

Plant Expenses	\$576,037
Depreciation & Amortization	\$646,771
Customer Operations	\$240,375
Corporate Operations	\$331,093
Other	\$71,204

Operating Income

As provided by the Applicant, Arizona Telephone Total Intrastate Operating Income for the Twelve Months Ending June 30, 2012 was negative \$774,462 before taxes and negative \$460,172 after taxes.

RATE BASE

According to Arizona Telephone, its rate base is \$3,873,823, as stated in the table below:

Arizona Telephone Company

Rate Base

As of June 30, 2012

	Total Company	INTERSTATE	INTRASTATE
Plant in Service	\$ 21,239,025	\$ 9,729,997	\$ 11,509,028
Accumulated Depreciation	(17,669,810)	(8,393,883)	(9,275,927)
Net Plant in Service	\$ 3,569,215	\$ 1,336,114	\$ 2,233,101
Plant Under Construction	378,532	173,432	205,100

¹ Universal Service Fund – High Cost Fund

Material & Supplies	37,316	11,261	26,055
Deferred Income Taxes	(271,187)	(124,952)	(146,235)
Cash Working Capital	159,947	82,943	77,004
Rate Base	\$ 3,873,823	\$ 1,478,798	\$ 2,395,025

CUSTOMER BASE

Arizona Telephone reported 2,036 residential lines and 770 business lines in its April 15, 2012 Utilities Annual Report.

REVENUE REQUIREMENT

As stated above, the Applicant's filing was based on a streamlined basis and rates will not be set based on rate of return regulation. Therefore, the Applicant's filing does not contemplate rate adjustments based on revenue requirement analysis.

RATE DESIGN

The Applicant did not propose a rate design as required by R14-2-103. The Applicant is seeking to increase its residential local exchange service rate by \$4.00. The Applicant's filing only contemplates changes to residence local exchange rates to compensate for the rate impacts of the FCC's USF/ICC order. With this filing, Staff will only address the monthly increase of all residence local exchange service rates to \$14.00.

STAFF ANALYSIS

Staff did not perform a regulatory audit of the information submitted by Arizona Telephone. However, Staff reviewed the information filed in the context of the FCC's November 18, 2011 USF/ICC Order which is intended to transition the outdated federal universal service programs and most intercarrier compensation systems into a new CAF.

Staff has analyzed this application in terms of whether there were fair value implications. For the purposes of this matter, the Applicant stipulated to the use of original cost less depreciation as the basis for a determination of its fair value rate base. The Applicant states that its intrastate rate base is \$2,395,025. The Applicant provided information that indicates that its Total Intrastate Operating Revenue for the Twelve Months Ending June 30, 2012 was \$1,121,018. According to the Applicant, the annual revenue effect of the increase in local telephone service rates to \$14.00 is \$94,752.² Compared to the Applicant's total revenues, any revenue impact from this rate increase would be small and any impact on the Applicant's fair

² Based on 1,974 one-party average residence lines.

value rate of return would be de minimus. Arizona Telephone's Operating Income would remain negative, therefore, the rate of return is not meaningful in this case, i.e., less than zero.

STAFF'S RECOMMENDATIONS

Staff recommends that the Arizona Telephone monthly residence local exchange rate increase from the residential local service rate of \$10.00 to \$14.00, beginning June 1, 2013, to address the impact of the FCC's USF/ICC Order. Staff believes the proposed increase is just, fair and reasonable for the following reasons:

- The increase is necessitated by the FCC's November 18, 2011 USF/ICC Order;
- The increase is necessary to preserve the entirety of the FUSF funds that may flow to Arizona Telephone pursuant to the FCC's rules;
- The increase will minimize/reduce the amount of future rate increase; and
- The increase will allow the Applicant to receive matching funds from the FUSF.

Staff has reviewed the rate application and the federal rule changes that have prompted the rate application. Staff concludes that the costs appear reasonable and appropriate under the unique circumstances of this case. However, Staff's recommendation in these unique circumstances should not be viewed as precedent for the processing of future rate case applications.